

EXHIBIT A.521

(6 of 17)

Palestinians returning to a new Palestinian state in "Prospects for Return Migration" below, we focus our discussion here on which of the alternative assumptions about the future course of Palestinian fertility appears to be most probable.

All of the projections discussed above assume that the fertility rates of Palestinian women will decline over the next 25 years. In fact, there is strong evidence to support this assumption because the number of children ever born to Palestinian women who are currently nearing the end of the reproductive years (ages 40 to 49) is significantly higher than current total fertility rates—a synthetic measure of projected total fertility.¹⁴ The key questions about future fertility are how far and how fast fertility rates are likely to drop. The various projections reported above use very different assumptions about these two issues. The low projection, for example, assumes that total fertility rates in the West Bank and Gaza will decline to the replacement level (2.1 children per woman) over the next 25 years. This represents a 63 percent decline in fertility among women in the West Bank and a 70 percent decline in fertility among women in Gaza. The medium projection, on the other hand, assumes that total fertility rates in both the West Bank and Gaza will decline by 50 percent over the next 25 years (these declines would reduce the total fertility rate in the West Bank and Gaza to 2.8 and 3.45, respectively). Finally, the high projection assumes that total fertility rates will decline by 30 percent over the next 25 years (these declines would reduce total fertility rates in the West Bank and Gaza to 3.9 and 4.8, respectively). Which of these assumptions most closely matches reality will determine not only the size of the total population in 2025 but also how much growth will occur thereafter.

Demographers have shown that women's reproductive behavior is determined by a combination of demographic and social factors (Davis and Blake, 1956). We have already noted, for example, that the number of births is strongly influenced by how many women are of childbearing age. How many of those women will actually bear children will be affected by several other demographic factors, e.g., the percentage of women who marry, their average age at marriage, their use of contraceptives, and the effectiveness of the contraceptive methods.¹⁵ Similarly, the number of children women bear is affected by what they consider their desired family size, which in turn varies depending upon what opportunities are available for women outside childbearing and childrearing, women's education levels, and their labor force patterns (McCarthy, 2001). Thus, to evaluate how plausible the various fertility assumptions used in these projections are, we now examine how Palestinian women compare across these various dimensions.

¹⁴ Unlike the number of children ever born, which reflects actual fertility behavior, the total fertility rate assumes that women will continue to have children at the same rate as women of various ages are currently bearing children, i.e., it sums the age-specific birth rates of women across various ages. Currently, the mean number of children ever born among women age 40–49 is 6.05 in the West Bank and 7.04 in Gaza. The comparable total fertility rates for those two areas are 5.6 and 6.9, respectively.

¹⁵ Another key factor in most cultures is the incidence of childbearing outside of marriage. However, we assume that this is very low in all Arab societies.

In several respects, marriage patterns among Palestinian women appear to fall between the patterns in the developed world and those in the balance of the Middle East and the rest of the less developed world. Among women of reproductive age (15 to 49), for example, about two-thirds are currently married, compared with about 60 percent in the developed countries and between 67 percent in developing countries and 71 percent in the Middle East as a whole. In addition, about 90 percent of all women eventually marry, as is true for the developed world. However, marriage patterns in Palestine differ sharply from those in the developed world in two respects. First, Palestinian women marry at much younger ages than in the developed world. The median age at which women marry in the Palestinian territories is 20, compared with 25 in the United States. Second, married women in Palestine appear much less likely to divorce or become separated from their husbands than those in developed countries. The PCBS, for example, reports that less than 4 percent of ever-married Palestinian women between the ages of 40 and 49 were divorced or separated from their husbands, compared with close to 18 percent of ever-married American women of similar ages.¹⁶ The net effect of these differences in marriage patterns seems to be that Palestinian women not only are exposed to the risk of childbearing at significantly earlier ages but also are substantially less likely to have that exposure cut off by divorce or separation than are women in developed countries. Since rising ages at marriage and increased marital disruption rates appear to have played an important role in reducing fertility in the developed world, these differences in marriage patterns would seem to militate against rapid reductions in fertility among Palestinian women.

Marriage patterns among Palestinian women are, of course, likely to change as they have in the developed world over the past few decades. Of the two marriage patterns discussed above, however, the age of marriage is more likely to rise than the rate of marital disruption. But the key to that change would appear to be increasing education levels among Palestinian women, since marriage ages are notably higher among Palestinian women who have at least 13 years of schooling.

Contraceptive practices can, of course, offset prolonged exposure to childbearing among married women, and there is evidence that contraceptive usage, particularly the use of modern contraceptive methods, is increasing among Palestinian women (PCBS, 2001). However, that increase is most pronounced among older women (ages 30 to 49). Overall rates of contraceptive usage among Palestinian women appear to lie slightly below the mid-range of international patterns (USBC, 1999). Moreover, the rate of usage of modern contraceptive methods among married Palestinian women does not appear to be related to education levels.

Traditionally, the sustained declines in fertility rates in the developed countries have been associated with changed views of childbearing. In high-fertility societies, large families often represent a form of social security—a conscious investment in the

¹⁶ The statistics reported here for Palestine come from the PCBS (2002); the data for the United States come from U.S. Department of Commerce (2001).

future. People tend to have many children to help with the labor of the family and to provide for the elderly when they can no longer work.¹⁷ Low-fertility societies, on the other hand, have a very different view of children and focus not on having many children but rather on having a few well-educated ones—"quality" rather than quantity (McCarthy, 2001). This attitudinal shift reflects the increased importance of work and economic mobility as well as a profoundly transformed view of women's role. Such a view is typically reflected in increasing levels of education and labor-force participation among women, as well as reductions in their desired family sizes. Although this view is most pronounced in the developed world, it is also increasingly apparent in the developing world.

The most recent data on desired family size among Palestinian women were collected in a 1995 survey conducted by the PCBS. Although the results of that survey suggest that desired family size is lower for younger women than for older women,¹⁸ the median ideal number of children per woman, 4.6, is still well above the total fertility rates used in the low and medium projections (between 2.1 and 3.5) and lies between the total fertility rates for the West Bank (3.9) and Gaza (4.8) used in the high projections. Of course, desired family size among Palestinian women may well decline during the next two decades. Indeed, although we have no information on desired family size by education level, the PCBS reports that Palestinian women with at least 13 years of schooling (the equivalent of some post-secondary training) have lower fertility rates than less well-educated women.¹⁹ Thus, there is reason to believe that fertility rates in the Palestinian territories will decline as education levels of women increase—particularly if more Palestinian women receive post-secondary training.

Although current educational levels among Palestinian women appear to be high relative to the balance of the Middle East, they are well below the levels found in developed countries. The PCBS reports, for example, that only 19 percent of adult Palestinian women have completed 12 years of schooling (secondary school), compared with 84 percent of adult women in the United States, and only about 7 percent have completed some post-secondary training (at least 13 years of schooling), compared with 24 percent in the United States.²⁰ However, the general pattern of rising school enrollment

¹⁷ In addition to these social and economic reasons for high fertility, Palestinian women may also be partly motivated by political reasons to the extent that high growth rates might be viewed as strengthening the Palestinian cause vis-à-vis Israel, which has much lower fertility.

¹⁸ The median reported ideal was over five children per woman among those age 40 and older and about 4.6 for those under 40 (PCBS, 1995). It is also interesting to note that total fertility rates among Palestinian Christians are substantially lower than those of Moslems (2.6 versus 6.2). However, the percentage of Christians living in Palestine has declined progressively over the past 100 years and is now less than 5 percent of the total Palestinian population (Fargues, 1998).

¹⁹ The total fertility rate among women with 13 or more years of schooling is 3.4, compared with over 5 for women with less education (PCBS, 2002).

²⁰ The figures for Palestine are derived from data reported in PCBS (2002). The U.S. figures are reported in U.S. Department of Commerce (2000).

rates in Palestine suggests that educational levels may rise sharply in the future, assuming that the disruptions caused by the current intifada are short term. Table 4.6, for example, compares school enrollment rates by age among Palestinian and American women. Although Palestinian girls start school on average a year later than American girls, their enrollment rates through age 13 are comparable. Female enrollment in the secondary-school years (ages 14 to 17) begins to drop off among Palestinian women—a difference that becomes more pronounced at older ages.²¹ Nonetheless, these enrollment rates suggest that the percentage of women age 18 and above who will complete at least some post-secondary education is substantially higher than in the population as a whole.

The degree to which increased schooling will translate into lower fertility, however, may well be conditioned by whether employment opportunities are available for women. Currently, women's labor force participation in Palestine is low by most developing country standards (UN, 2001). However, the rate at which Palestinian women participate in the labor force is very strongly related to their education levels. For example, the PCBS reports that half of all working-age women with at least 13 years of schooling are in the labor force, compared with 18 percent of women with 10 to 12 years of schooling and 12 percent of women with less than 9 years.

In conclusion, although the fertility rates of Palestinian women seem certain to decline, the extent and pace of that decline appears to be contingent on increasing their education levels and employment opportunities. If these factors lag, so too will the pace and extent of their fertility decline. If, on the other hand, they can be expanded significantly, fertility rates will decline at a faster pace and so, correspondingly, will the rate of population growth.

Table 4.6
Comparison of Female School Enrollment Rates
by Age in Palestine and the United States (%)

Ages	Palestine	United States
5–6	54	95
7–9	99	98
10–13	97	99
14–15	84	98
16–17	62	94
18–19	33	63
20–21	18	47
22–24	5	27

SOURCES: PCBS (2002), USBC (1999).

²¹ Interestingly, female school enrollment rates are higher than those of males in Palestine until ages 18–19, when they lag behind. In the United States, females actually have higher enrollment rates than males—although the differences are not large.

Implications of Population for the State-Building Process

As we discussed above, the size and characteristics of the population in a new Palestinian state will affect the state-building process by determining the natural and physical resources needed to sustain the population; by influencing the demand for services and the ability to support those service levels; and by shaping the demands placed on the economy. In this section, we examine each of these issues in turn.

Carrying Capacity

Palestine will begin statehood with the second-highest population density in the Arab world: 567 persons per square kilometer, second only to Bahrain at 1,014 persons per square kilometer. And in light of the population projections described above, this density will increase to between 958 and 1,457 persons per square kilometer over the next 25 years. Moreover, these are averages for the entire Palestinian territory and thus mask the considerable difference between the West Bank and the much more densely settled Gaza, where population density is already 3,457 person per square kilometer—a figure that rivals Singapore and Hong Kong,²² two of the most densely settled regions in the world.

These statistics raise the question as to whether a new Palestinian state has or will in the near future reach its “carrying capacity”—the total population that the nation’s land and resources can sustain. However, as the comparison with Hong Kong and Singapore suggests, the challenge of coping with increasing population density depends less on physical limits and more on how a society and its economy are organized and what financial and technological resources it has at its disposal for coping with increasing population size and density. In other words, the real issues are costs and resources. In the years since Malthus predicted that population growth would eventually outstrip the growth of available resources in 1798, global population and income levels have both expanded multifold—exactly contrary to his theory.

Although the exact costs of adjusting to continued rapid population growth in Palestine are unknown, it is certain that they will be substantial and are likely to include not only financial resources but also economic and social adjustments. Major changes are likely to be required in three areas: water, land use, and infrastructure.

As Chapter Six makes clear, the pressures upon water sources and water infrastructure in the Palestinian territories are already severe and will probably worsen in the future. That analysis reveals that current Palestinian water consumption averages half the United Nations’ per-capita minimum daily standard and that total consumption in the region (by Israelis and Palestinians combined) exceeds the renewable supply, with the most severe problem in Gaza. As Chapter Six also notes, several factors con-

²² The population densities in Hong Kong and Singapore are 6,570 and 5,540, respectively (CIA, *World Factbook*, 1999).

tribute to this problem, including the greater share Israel takes of the available water stocks, the fact that agricultural irrigation uses about half of Palestine's water, and the deterioration of Palestine's water infrastructure. In light of expected population growth and the increased demand for water, it seems clear a new Palestinian state will need to take several steps to deal with its water problem, including negotiating with Israel for a larger allocation of shared water resources, upgrading its water infrastructure (including developing desalination facilities), reducing its dependence on irrigated agriculture, and using its available water resources more efficiently. Meeting the costs of such actions will require substantial international assistance.

A second critical resource that will be stressed by rapid population growth is land. The entire Palestinian territory comprises a total of 2,400 square miles—a little more than half the area of Qatar and about one-fifth the size of Belgium. The available land will need to accommodate a wide variety of uses, including infrastructure, other public uses, a variety of economic uses (approximately one-quarter of the total land is currently used for agriculture), housing, and open space. An expanding population will increase the demand for all these uses. For example, the PCBS reports that there are an average of 6.4 persons per housing unit in Palestine. Assuming that this occupancy rate, which is currently high by developed country standards, were to be maintained, then accommodating population growth of between 2.2 and 5 million new residents during the next 25 years would require adding between 310,000 and 780,000 new housing units to the existing stock. Clearly, the government of a new Palestinian state will face difficult choices in managing the allocation of land among competing uses.

Finally, the physical infrastructure of the West Bank and Gaza needs substantial upgrading. A 1993 World Bank report underscores the infrastructure problems of the West Bank and Gaza, including the shortage of water supply, low and sporadic electricity supplies, a solid waste collection and disposal system that is grossly inadequate and raises serious health and environmental concerns, a road system that has deteriorated to the point where past investment may be completely lost, and a low ratio of telephones to population (World Bank, 1993). This appraisal was made, of course, prior to the further damage that has been done to Palestine's infrastructure during the current intifada and does not consider the additional requirements that continued rapid population growth will bring. Moreover, even in areas where the existing infrastructure is in better condition (e.g., health care), the organization of that system relies too heavily on high technology delivered in small inefficient units and must be improved. In sum, added population growth will only increase the need for investment in what is already a problematic physical infrastructure.

Service Demand

As we noted in the Introduction, the political viability of a new Palestinian state will be affected by its ability to meet its citizens' service needs. Population growth of the magnitude we have discussed will, of course, increase demand for services across the

spectrum. But, as we have also noted, a population's age structure is perhaps the most important factor in determining service demand. Both the young and the old are intensive service users, in contrast to the working-age population, who have the primary responsibility for paying for those services.

Three areas of service demand are especially prone to feeling the impact of rapid population growth: education, health care, and housing. Population growth affects the demand for physical infrastructure (new schools, health care facilities, and homes); the demand for trained personnel to staff the new schools and health facilities; and the political pressures to change policies that influence the quality and organization of the services delivered.

The Palestinian education system is known throughout the Arab world for its effectiveness, universality, and secular character.²³ It produces more university graduates per capita than almost any other Arab state and offers education to virtually all Palestinian youth who wish to attend primary and secondary schools. Moreover, before the current intifada, the level of academic achievement among adults and enrollment rates among youth appeared to have been increasing. Nonetheless, as we noted above, measures of completed schooling and current enrollment lag well behind comparable rates in the developed world.

Despite Palestine's current educational achievements, there are several reasons why increasing education levels further will be important to the country's future. First, given the small area of the Palestinian state and its limited natural resources, its human capital is likely to be its most important economic asset, so increasing the skill levels of its population will be the key to future economic development. Second, increasing enrollment rates among those currently of school age and those who will be of school age in the future can provide some short-term relief from what are certain to be growing pressures on the economy to provide employment to a rapidly expanding labor force. Finally, as we have discussed above, increasing educational achievement among Palestinian women can reduce future population growth by increasing age at marriage, reducing desired family size, and reducing actual fertility levels.

Currently, Palestine's primary and secondary schools have slightly over one million students divided among government schools (72 percent of total enrollment), United Nations Relief and Works Agency (UNRWA) schools (22 percent), and assorted private schools (8 percent). In addition, about 90,000 students are enrolled in Palestine's universities and colleges.²⁴ The system's primary and secondary schools are currently staffed by close to 38,000 teachers, in addition to about 3,500 who teach at the post-secondary level.

A new Palestinian state will be required to increase educational expenditures for both the physical infrastructure (schools and classrooms) and the human resources

²³ See Chapter Eight for more detail.

²⁴ These figures, which are based on data provided by the PCBS (2002), may overestimate current enrollment totals, which appear to have declined somewhat as a result of the current political problems in Palestine.

(teachers) needed to accommodate the dramatic increase in enrollment expected over the next few years. For example, during the current decade, the number of primary and secondary school students is expected to increase by 50 percent (at current enrollment rates)—a figure that will require the addition of over 15,000 new classrooms at the current ratio of 35 students per class.²⁵ Increasing enrollment at the post-secondary level would require a similar expansion of university and college facilities. Similarly, assuming that student/teacher ratios remain at current levels, accommodating the increased enrollments expected at the primary and secondary levels during the current decade will require the hiring of another 18,000 or so teachers.

Since the Palestinian population will continue to grow at a relatively high rate at least until 2025, these initial expenditures are likely to be a mere down payment on future educational expenditures. Whether a new Palestinian state will bear the full costs of these expected changes in educational service levels will depend upon the status of the UNRWA schools, which are funded by the United Nations, and the private schools, many of which are funded by international donors. If UNRWA ceases operations in Palestine subsequent to the establishment of a Palestinian state and if international donors reduce their financial support to the privately run system, then the financial impact on the new Palestinian state will be correspondingly greater.

In addition to the costs of accommodating these enrollment increases, a new Palestinian state will also be required to deal with a series of policy issues that may potentially influence service levels and expenditures. At the secondary level, for example, the Palestinian educational system suffers from a dearth of vocational training programs, which reduces both the school enrollment rates of those who do not wish to pursue academic training and the skill level of the labor force. Similarly, post-secondary students are disproportionately concentrated in the humanities and social sciences rather than the physical sciences and engineering. Addressing these imbalances will pose further financial and organizational challenges to the educational system.

As we have already indicated, the physical and human capital infrastructure of the Palestinian health care system appears to be in reasonably good shape.²⁶ Both the number of hospitals and the number of beds, for example, have been increasing steadily over the past decade. Indeed, the most significant problem with the current infrastructure is its inefficient geographic distribution—for instance, cancer centers are present in towns with a greater need for maternity facilities and vice versa. Nonetheless, the pace of population growth over the next decade will require a 60 percent increase in hospital beds and medical personnel to keep those indicators of service levels at their current ratios.²⁷

²⁵ These additional students could, of course, be accommodated with fewer new schools by increasing class size or running multiple shifts—a phenomenon that has already been occurring.

²⁶ The state of Palestine's health care system is discussed in greater detail in Chapter Seven.

²⁷ We lack the current information on medical personnel needed to calculate what this expansion would require. However, data from PCBS (2002) indicate that about 3,000 new hospital beds (above the 5,000 currently available) would be required to keep the ratio of hospital beds per 1,000 population at its current level of 1.4 beds per 1,000 population.

In light of current levels of physical and human capital in the health sector, the greatest challenge facing the health system in a new Palestinian state in light of increasing population seems likely to be in the area of health finance. Currently, the Palestinian National Authority provides universal access to immunizations, pre- and postnatal care, and care for children under three. Other care, particularly secondary and tertiary care, requires government-sponsored health insurance, except for those patients who can afford to pay for care in private clinics and hospitals. In addition, the liabilities of the Palestinian Ministry of Health exceed its annual budget.²⁸ Thus, the capacity of the Palestinian health sector to continue providing financial access to health care may be in doubt without major infusions of international assistance.

Housing is a third area in which population growth is likely to place substantial stress on service delivery in a new Palestinian state. In our discussion of land use above, we noted that a Palestinian state will need to add between 310,000 and 780,000 new units of housing stock (above the current total of 390,000) to accommodate projected population growth. However, that figure does not take into account either current access to electricity, water, and sewer facilities or the degree of crowding. At present, only about one-third of all occupied housing units in Palestinian territories are connected to water, electricity, and sewage facilities; less than one-half have access to both electricity and running water.²⁹ Clearly, a Palestinian state will face pressures not simply to expand the current stock but also to upgrade the quality of its housing. Furthermore, a 1995 survey indicated that about one-third of all households in the Palestinian territories were living in housing units at a density of over three persons per room. Although about 80 percent of all housing units in the Palestinian territories appear to be owner-occupied,³⁰ a new state will no doubt feel pressure to provide access to financing to relieve this level of overcrowding. Finally, the preceding estimates of required new housing assume constant household sizes. Although this assumption is probably reasonably accurate in the short run, it is likely to increasingly underestimate the scale of new housing required as fertility levels decline and average household sizes become smaller.

Demographic Pressures on the Palestinian Economy

Finding gainful employment for its growing working-age population will be among the most pressing problems facing a new Palestinian state. Although a Palestinian state will no doubt rely initially on international aid, the long-term viability of the state will be contingent on the ability of individual Palestinians to earn an adequate living and on the state's ability to generate sufficient revenues to satisfy the service needs of its residents. Given its economic structure and history, this will not be an easy task—even without the rapid growth of its labor force in the future.

²⁸ See Chapter Seven.

²⁹ See table, "Occupied Housing Units by Availability of Public Services," PCBS, 2002.

³⁰ See Demographic Survey, PCBS, 1995.

Historically, Palestinians in the Palestinian territories have depended upon work in Israel and on remittances sent from Palestinian workers elsewhere in the Middle East for a significant share of their income. However, neither of these two sources of employment appear to be as viable in the future as they have been in the past. At its peak, the number of Palestinians making the daily commute to Israel for employment totaled 130,000 (Davoodi and von Allmen, 2001) but that number has dropped precipitously. Indeed, the number of Palestinians living in the West Bank and Gaza but working in Israel has dropped from almost one-quarter of all employed Palestinians in 1999 to less than 10 percent today.³¹ Moreover, the perception that Palestinian workers represent a security threat to Israel has prompted the Israelis to replace low-wage Palestinians with other foreign workers. Even if a peace agreement is signed, it is unclear whether the number of Palestinians working in Israel will ever rebound to its earlier high point.

The prospects of Palestinian workers finding employment elsewhere in the Middle East also seem to have declined sharply. As we noted in our review of historical Palestinian migration patterns, the large-scale movement of Palestinian workers to the Gulf states terminated over three decades ago, as those countries became increasingly reluctant to import Arab labor in the face of rising unemployment among their own citizens. There are no signs that this reluctance will diminish in the foreseeable future.

The prospects for employment growth in the West Bank and Gaza are also uncertain. Although employment levels have dropped since the onset of the current intifada,³² it is unclear which sectors of the economy are best suited to absorbing the existing labor force. Currently, the two largest employment sectors of the economy are agriculture (about 15 percent of total employment) and services (about 35 percent—a substantial fraction of which consists of public-sector employment). Growth in the agricultural sector is likely to face constraints due to limited natural resources (land and water), and international financial institutions like the World Bank are already demanding reductions in public-sector employment as a way to streamline the Palestinian economy. However, a study conducted in the late 1990s indicated that residential construction, tourism, consumer electronics, cut flowers, olive oil processing, software development, and stone and marble processing could all be viable industries in Palestine (Davoodi and von Allmen, 2001). Moreover, given the infrastructure needs described above, residential and commercial construction would seem to offer a significant source of employment,³³ at least in the short run.

³¹ See "Number of Palestinians in Israel for Selected Years," www.pcbs.org/english/abs_pal/abs_pal2/Qudsb/1.2.htm.

³² Although we lack data on total employment levels, the labor-force participation rate among prime-age men has declined to 65.5 percent (from 70.7 percent) and among females from 12.7 to 10.4 percent during the past four years (PCBS, 2002).

³³ A more detailed discussion of Palestine's economic prospects is contained in Chapter Five.

The challenges facing the Palestinian economy as it seeks to find adequate employment for its current labor force will, of course, be compounded by the fact that this labor force is growing rapidly and will continue to do so for the foreseeable future. One indication of this growth and the challenges it will pose is that the age group that will be entering the labor force over the next ten years (ages 10 to 19) is seven times as large as the age group that will be moving out of the working years (ages 55 to 64).³⁴ Although this ratio overstates the number of new jobs that must be found to accommodate labor force growth since it includes women (who have very low labor force participation rates) as well as males who, for schooling and other reasons, will not be looking for work, it does suggest the magnitude of the challenge facing the Palestinian economy. Moreover, the Palestinian economy could certainly benefit from increasing labor force participation rates—both among men, many of whom may have dropped out of the labor force due to the current political turmoil, and especially among women as an indirect means of reducing fertility and thus future population growth.

Ironically, in light of these employment challenges, the strongest economic asset of the new Palestinian economy is likely to be its human capital. Certainly, it is the only one of the principal factors of production (land and natural resources, technology, and labor) that Palestine has in abundance. Moreover, given the relatively high educational levels of Palestinians, if this labor force can be gainfully employed, it could be a major factor for promoting economic growth. To take advantage of this asset, however, the new state will need to continue to increase the education and training levels of the population, as well as find a solution to the daunting structural problems it faces.

Prospects for Return Migration

The number of diaspora Palestinians who move to a new Palestine state will be critical to the political and practical viability of that state. In this section, we first review the reasons why this issue is so important. Next, we discuss some of the technical aspects of the return migration from a negotiating perspective. Finally, we estimate the potential sizes of various return flows and the conditions under which they might occur, and we discuss the implications for a new Palestinian state.

Importance of the Issues

From a political perspective, the plight of diaspora Palestinians symbolizes the predicament of the Palestinian people. Palestinians lack a homeland. Other states and parties (e.g., Israel, the United States and the other Roadmap states, and the host states in which Palestinians live) control their fate. Until they gain statehood (sovereignty) and

³⁴ The current population ages 10 to 19 totals a little less than 600,000 whereas the population ages 55 to 64 is 84,000.

control over their fate, Palestinians will not have achieved their ends and their struggle will most likely continue. Thus, solving the refugee issue assumes a tremendous symbolic importance to Palestinians.

Given the symbolic importance of refugees and return migration to the Palestinian identity, how the Palestinian leadership deals with these issues will provide a critical test for that leadership's legitimacy for several reasons. First, the predicament of Palestinian refugees, particularly those living in camps in Lebanon, serves as a continuing source of discontent to all Palestinians and as an ongoing rationale for the armed struggle. Thus, a satisfactory solution to the refugee issue will play an important role in determining whether a negotiated settlement ends the ongoing violence. Second, how the Palestinian Authority deals with the refugee and return migration in the negotiation process will serve as a central test of its effectiveness as an advocate for the Palestinian people as well as how that settlement is viewed by Arab states and others. Third, as we discussed above, how many and which Palestinians migrate to Palestine will have tremendous practical economic and social implications for the future viability of the new state. In addition to the number and size of the return migration, the period over which it occurs will also affect the eventual size of the population in the new state.³⁵ Fourth, not only is the refugee issue of great importance to Palestinians, it is also of direct concern to Israelis since it could have a direct effect on Israeli security, the interests of Israeli settlers, and—depending upon how many Palestinians return and where they settle—on the essential Jewish character of the Israeli state.³⁶ Indeed, the importance of this issue to the Israelis was encapsulated in the statement by a prominent Israeli commentator who stated that “any settlement that fails to completely solve the refugee problem will not provide a realistic and durable settlement” (Gazit, 1995).

In sum, resolution of the refugee and return migration issues will be central to a successful conclusion to the peace negotiations. Indeed, given their importance to both parties, it is not surprising that the refugee issue was designated a final status issue in the original Oslo Accords and is thought to be one of the major reasons that the Palestinian Authority was unwilling to accept the peace agreement offered by the Barak government.

Key Issues

Although the formal terms on which the refugee issues will be negotiated are not altogether clear, a host of potential issues could be on the table. Who will be eligible to return and who should be given priority? Will eligibility be limited to registered refugees and their immediate descendants and, if so, which ones should be given priority—the original 1948 refugees, the 1967 displaced persons, or those currently living in refu-

³⁵ As the projections reviewed above indicate, natural increase among returnees could substantially increase the amount of population growth.

³⁶ All of the initial refugees were displaced from land that is now part of Israel. If return entails resettlement on that land, it could definitely affect the demographic balance between Jews and Arabs in Israel.

gee camps? Alternatively, should priority be given to those who might make the most immediate contribution to a new Palestinian state? As we have indicated above, the original refugees (both 1948 and 1967) are now outnumbered by their descendants. The number of registered refugees is only a fraction of the total Palestinian population outside the Palestinian territories, just as the number of refugees living in camps is only a fraction of the total number of registered refugees. Thus, how the eligible population is defined will help shape not only how many Palestinians may decide to return but also what effects they are likely to have on the economy and the service demands placed on the new state.

A second key issue is what is meant by "return." There are currently several viewpoints. Return may be defined as the physical return of refugees to their original homes and land in Mandate Palestine, including land in Israel that is currently occupied by Israelis. Or it may refer only to return to Palestinian territory in the West Bank and Gaza or in "swapped" land.³⁷ Alternatively (or in addition) it may refer to some kind of financial settlement for lost property in lieu of actual physical return. Finally, is it sufficient just to return to Palestine—even if this means moving returnees from a camp in Lebanon to a new camp in the West Bank and Gaza—or does it require that individuals be relocated outside refugee camps?

Third, what conditions and timetable will govern the return process? This question really encompasses a wide range of issues, such as the timetable for return, the conditions (for example, security levels) that must be met for return to proceed peacefully, who will administer and monitor the return process (the Palestinians, the Israelis, some neutral third party, or a multilateral commission), and what role, if any, UNRWA will play in the return process and in Palestinian refugee affairs in the future.

Finally, apart from the issue of who is eligible to return, there is the question of how many diaspora Palestinians might actually wish to return. The answer to this question is likely to depend upon many factors. For example, a survey conducted among Palestinians living in Jordan and Lebanon indicated that the proportion who might return would vary not only with the terms of the agreement but also with such factors as whether they have relatives currently living in Israel, the Palestinian territories, or elsewhere (e.g., in a third country); whether they currently live inside or outside refugee camps; their current incomes; and whether they own land in the country of their current residence (Shikaki, 2003). Other factors—such as economic and political conditions in the new Palestinian state, how these conditions compare with those in the countries of current residence, and the attitudes of host governments toward Palestinian residents remaining in their countries after statehood—will also play a role in determining how many and which diaspora Palestinians might choose to return.

³⁷ The December 2000 Clinton proposals, the January 2001 Taba negotiations, and the October 2003 Geneva accord all foresee land swaps whereby Israel annexes a small amount of West Bank land where settlements are concentrated in exchange for Palestine annexing current Israeli territory.

Estimates of Potential Returnees

Our estimates of the range of potential returnees are derived in two steps: First, we identify which groups of Palestinians are most likely to return; second, we estimate a range of potential return rates depending upon the options returnees might be given with regard to where they may settle. Potential return rates for different groups of Palestinians and under different conditions are estimated using results from a recent survey of Palestinian refugees living in the West Bank/Gaza, Jordan, and Lebanon.³⁸

As we reported in Table 4.1 above, approximately 5.4 million people of Palestinian origin live outside the Palestinian territories. Close to 1 million of them live in what we have termed the “far abroad” regions. Since this particular group includes many of the most highly skilled and economically successful Palestinians, it seems unlikely that any substantial number would consider resettling in a new Palestinian state before a stable and nonviolent political climate is well-established, the government is up and running, and the prospects for a successful economy well-grounded. Instead, the most likely candidates for return, at least in the short run, will be found among the 3.5 million Palestinians living in the surrounding states of Lebanon, Syria, and Jordan.³⁹ Approximately 70 percent of these Palestinians (or roughly 2.5 million people) are registered refugees. Of this latter group, about one-quarter (or roughly 650,000 people) are currently living in refugee camps. Although the living conditions and political rights of Palestinians living in these surrounding states and in various refugee camps within these states differ,⁴⁰ it seems highly likely that the prime candidates for return will be the registered refugees in general and those living in refugee camps in particular. Thus, we estimate that the potential pool of returnees will be between 650,000 (those living in refugee camps) and 2.5 million (those who are registered refugees).

In the survey referenced above, respondents were asked a series of questions about how they might respond to different resettlement options, including what their first choice for permanent residence was; under what conditions they would consider moving to Israel; and whether they would move to Palestine if the refugee and resettlement issues were excluded from a peace agreement but resolved later (referred to subsequently as the “permanent minus” option). We used the responses to these questions to estimate a range of return rates that might apply under different return options. The resulting estimates of the number of returnees are listed in Table 4.7.

The first three rows of this table compare the size of different groups of Palestinians who currently live outside the West Bank and Gaza. The first row lists the total

³⁸ Shikaki (2003).

³⁹ Approximately 1 million Palestinians currently live in Israel. Although some of those Palestinians might consider moving to a new Palestinian state, the number of such migrants is not likely to be very large since, unlike the diaspora Palestinians, most are not refugees who were displaced from their original homes in Mandate Palestine.

⁴⁰ Palestinians living in Jordan have the benefits of citizenship and are well integrated into the Jordanian economy and society; Palestinians living in Syria are integrated into the Syrian economy but lack citizenship; and those living in Lebanon lack citizenship and are not integrated into the Lebanese economy or society.

Table 4.7
Estimates of Potential Return Migration by Area of Current Residence

	Potential Immigration (thousands)				Total
	Jordan	Lebanon	Syria	Other	
Total population	2,720	400	400	1,830	5,350
Registered	1,700	390	400	0	2,490
In camps	300	220	120	0	640
Low 1	75	70	40	0	185
Low 2	425	120	110	0	655
Medium	460	75	90	5	630
High 1	630	160	160	5	955
High 2	715	250	210	10	1,185

NOTES: Assumptions—Low 1: Population living in camps multiplied by the percentage who report that they would return to Palestine under the permanent minus option. Low 2: Registered refugees multiplied by the percentage who report that they would return to Palestine under the permanent minus option. Medium: Registered refugees multiplied by the percentage who report that their first choice is to move to Palestine. High 1: Registered refugees multiplied by the percentage who report that their first choice is either to move to Palestine or to swapped areas. High 2: Registered refugees multiplied by the percentage who report that their first choice is either to move to Palestine, to swapped areas, or to Israel.

number of Palestinians who live in each area. The second row lists the number of registered refugees in each area. The third row lists the number of refugees living in camps in each area. As the very different size of these groups suggests, the number of migrants who might return to a new Palestinian state will depend upon whether each of these groups is equally likely to move to a new state. As we indicated above, we do not believe equal rates of return migration to be likely. Instead, we expect that the propensity to migrate will be selective in two ways: first, by area of current residence; second, by refugee status. Specifically, we anticipate that the vast majority of returnees (at least in the short run) will come from the surrounding countries and, within those populations, predominately from registered refugees—particularly those currently living in refugee camps.

The next five rows of the table list a range of estimates of the number of migrants who might move to Palestine under various conditions. The rates used to calculate these estimates are based on the responses given to two questions in the survey described above. The first question asked respondents to identify their first choice of residence if they were free to move wherever they wanted. The range of options included Israel, the new Palestinian state, areas within Israel that would later be swapped with Palestine as part of a territorial exchange, remaining in their current country of residence, or moving to a third country. The second question asked respondents to indicate whether they would move to Palestine even if a formal peace agreement left the issue of refu-

gee resettlement unresolved and subject to later negotiation. Since the permanence of such resettlement as well as the rights of the returnees would remain unresolved under this permanent minus condition, we assume that respondents who would nonetheless resettle in Palestine are the most likely to move under any circumstances. In making our estimates, we multiplied the various rates calculated from the data by two different populations: the number of refugees currently living in camps and the number of registered refugees. The pairing of populations and return rates is identified in the table notes. Since the survey data did not include Palestinians living in Syria, we calculated estimates for that country as the average of the rates from Jordan and Lebanon.⁴¹

The resultant estimates fall within a wide range—between a low of about 185,000 returnees and a high of close to 1.2 million. As reflected in the difference between the moderate and high estimates, how the issues of swapped land and Palestinian return to Israel proper are resolved could make a substantial difference in how many Palestinians actually return.⁴² On the other hand, for reasons discussed above, we do not expect that many Palestinians currently living in the far abroad or Israel are likely to move to a new Palestinian state, at least in the foreseeable future.

These estimates, of course, are only as valid as the assumptions used to calculate them. Nonetheless, they can provide a rough guide as to how return migration to a new Palestinian state might affect population growth in that state as reflected in the population projections reported in Table 4.5. Since these estimates generally fall near the low end of the net migration assumptions used by the USBC and the PCBS in their projections, they suggest that the total population growth in a new Palestinian state may be more likely to fall at the high end of the medium fertility–high migration projection—in other words, close to 7.5 million by 2025.⁴³

One issue that is not built into our migration estimates but is incorporated into the population projections discussed above is the timing of the potential return migration. The survey data used for our estimates also included information about the respondents' preferences as to the timing of any return migration. These data indicate that close to two-thirds of Palestinians currently living in the Palestinian territories and in Jordan would prefer that the return migration take place gradually. About 60 percent of the Palestinians living in Lebanon, on the other hand, want the return to happen all at once. Although this difference may be understandable given the living conditions in Lebanon, it not only could increase the adjustment problems that return migration

⁴¹ The rationale for using the average of the Jordanian and Lebanese rates was the fact that the economic and political status of Palestinians living in Syria appears to lie between their status in Jordan and Lebanon.

⁴² The conditions applied to Palestinian migrants to Israel would also make a substantial difference in the number who actually return. As Shikaki's (2003) data make clear, although approximately 235,000 Palestinians list Israel as their first choice, only about 10,000 would actually return if they were forced to become Israeli citizens.

⁴³ The USBC assumed 100,000 net migrants and the PCBS assumed 500,000. These estimates refer to net migration (immigrants minus outmigrants), whereas the estimates in Table 4.7 refer only to immigrants. However, we do not expect this difference to make a substantial difference in the size of the net flows.

might engender but also would have a larger multiplier effect on the eventual size of the Palestinian population (through natural increase to return migrants).

As the discussion in this chapter has made clear, estimates of the range of return migration to a new Palestinian state are wide. Moreover, they generally exceed the net migration assumptions upon which the population projections reported earlier are based. Thus they are likely to compound the problems of population growth in a new Palestinian state. Although there can be no definitive answer to the question of how many Palestinians might move to a new Palestinian state, it is clear that the more refugees Palestine absorbs, the greater the overall cost and the fewer the resources available for other needs. Conversely, fewer refugees means lower cost to the state and more resources available to provide for the needs of the existing population.

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CHAPTER FIVE

Economics*Justin L. Adams, Kateryna Fonkych, Keith Crane, and Michael Schoenbaum***Summary**

The economy of an independent Palestinian state will be the engine of opportunity for its citizens. To provide sustained growth in per-capita incomes, Palestine needs a dynamic private sector that can employ the current and future labor force. The economy will need to be diverse and resilient enough to withstand economic or political shocks and open enough to participate fully and competitively in the world economy. To foster such an economy, the future Palestinian government will need to

- surmount the many challenges facing the Palestinian economy, especially those posed by the need for regional security
- make strategic choices and choose policies that will contribute to the development of the Palestinian economy
- attract the investment needed to create the infrastructure and industrial base needed for sustained growth.

The Palestinian Economy

The Palestinian economy is very small. Palestinian gross national income (GNI) of \$5.2 billion in 1999 yielded a per-capita income of nearly \$1,800 annually, placing the West Bank and Gaza in the range of lower-middle-income countries. A significant portion of GNI (about 17 percent) over much of the past three decades has been derived from wages paid to Palestinians employed in Israel and the settlements.

The Palestinian economy is geared mostly to providing services and producing nontradable goods, and it is also highly dependent on trade. Israel is Palestine's main trading partner, having gained control of the West Bank and Gaza in 1967. Trade flows between them are skewed, however: Israel runs a very large trade surplus with the West Bank and Gaza. Israeli wage payments greatly exceed Palestinian exports as a means of funding Palestinian imports of Israeli goods and services.

Israeli control has made the Palestinian economy very sensitive to economic and political shocks emanating from Israel. During the 1970s through the 1990s, inflation and economic cycles in Israel strongly affected inflation in the West Bank and Gaza

and demand for Palestinian labor. However, these economic effects have been superseded by the effects of Israeli security policies in the West Bank and Gaza that were taken in response to the intifadas. Restrictions on the movement of goods and people, the destruction of capital, and the construction of a road network restricted to Israeli access have had devastating effects on the economy of the West Bank and Gaza. Since 2000, per-capita incomes have declined by one-half.

Major Challenges and Issues

The Palestinian economy holds promise because of its substantial human capital, assuming that the international community is willing to invest in reconstruction. But the economy will face a number of significant challenges. First, sustained economic growth will require security and political stability. Second, the Palestinian authorities will have to create conditions for employing a large and rapidly growing labor force. Third, the West Bank and Gaza have little in the way of developed economic sectors: Many industries would need to be developed from scratch. Fourth, the Arab world provides a logical market for Palestinian products, but the West Bank and Gaza have weak economic relations with their Arab neighbors. Fifth, rapid population growth, the possible immigration by a large number of Palestinian refugees to the West Bank and Gaza, the destruction of physical infrastructure related to the intifada, and a poor initial infrastructure base will require substantial investments in roads, water, electric power, and other infrastructure. Sixth, Palestinian businesses lack access to private-sector capital. Finally, Palestinian governing institutions have yet to show signs that they can create a business environment conducive to rapid economic growth.

Strategic choices made by policymakers at the outset of the new state will markedly affect the path of its economic development. Decisions about *geographic contiguity*—the size, shape, and fragmentation of a future Palestinian state, the inclusion of special sites or areas, and control over land and resources—will determine the resources that the Palestinian Authority (PA) will have at its disposal to foster growth and the ease with which Palestinians can move and engage in business. Decisions about the degree of *economic integration* with Israel in terms of trade and the mobility of Palestinian labor will shape the Palestinian economy, the rate of economic growth, and prospects for employment.

Economic Scenarios and Implications

The future Palestinian state can be considered within the framework of four scenarios, determined by decisions about geographic contiguity and economic integration. We analyze these scenarios for the 2005–2019 time frame, quantifying what each scenario implies for economic growth and identifying the level of investment needed to achieve sustained economic growth and improved living standards.

Our analysis indicates that under each scenario except the low-contiguity/low-integration case, Palestine could reasonably surpass its 1999 per-capita GNI by 2009 and nearly double it by 2019. But achieving this income growth would require significant investment in Palestinian capital stock: Between 2005 and 2019, the Palestinian private and public sectors and the international community would have to invest around \$50 billion under each scenario, averaging about \$3.3 billion a year, to achieve these rates of growth.¹ Regardless of the scenario, domestic private employment would have to grow at a substantial pace (perhaps at an annual average of 15 to 18 percent) between 2005 and 2009 to reach rates of employment last seen around the summer of 2000. These employment rates should be possible once Palestinian businesses are able to operate in a relatively unrestricted environment and are fully able to utilize available resources.

Policy Options

We discuss best-practice economic policy options for Palestine that would help to support its economic development, regardless of the scenario in which it found itself. Policies fall into eight general categories:

1. Fostering free trade by minimizing the costs of commerce
2. Partnering with its neighbors to develop specific economic sectors and to leverage infrastructure
3. Investing in infrastructure for transportation, water and power, and communications
4. Facilitating Palestinian employment in Israel by implementing appropriate security measures that make employment feasible
5. Expanding access to capital through a program of industrial estates/economic development zones, reformed domestic banking policies, and an international insurance fund
6. Choosing currencies to minimize inflation and economic volatility
7. Improving the business climate through increased transparency and accountability of Palestinian governance
8. Investing in human capital by improving the education system.

Introduction: Overview of the Palestinian Economy

The economy of an independent Palestinian state will be the engine of opportunity for its citizens. To foster an economy that can provide sustained growth in per-capita incomes, Palestine needs a dynamic private sector that grows rapidly enough to employ the current and future labor force. The economy must also be diverse and resilient

¹ All dollar amounts in this chapter are 2003 U.S. dollars and are expressed approximately unless otherwise noted.

enough to withstand the effects of economic or political shocks, and, particularly in light of Palestine's small size, open enough to participate fully and competitively in the world economy.

In this chapter, we explore the issues surrounding how a Palestinian state can achieve such sustained economic growth over its first 15 years. We first examine the current state of the economy in the West Bank and Gaza, including development since 1967. Second, we describe the major challenges and issues confronting the generation of sustainable economic growth. Third, because the details of a Palestinian state have not yet been determined, we consider how different initial conditions are likely to influence the path and ultimate success of economic development. Fourth, we analyze the implications of these scenarios, with an eye to quantifying the amount of investment needed from the private sector and the international community to achieve sustained growth in per-capita incomes. Finally, we discuss a number of best-practice economic policies for Palestine that can help stimulate economic growth regardless of its initial conditions.

Snapshot of Palestinian Economy in 1999

The economy of the West Bank and Gaza is small. In 1999, the year before the onset of the second intifada, the West Bank and Gaza (excluding East Jerusalem) had a gross domestic product (GDP) of \$4.3 billion. GNI was higher, \$5.2 billion, because of the additional income earned by Palestinians employed in Israel. The resulting per-capita income of nearly \$1,800 a year placed the Palestinian economy in the group of lower-middle-income countries (World Bank, 2002c, p. 8).² This figure is comparable to the per-capita income of Jordan but is only about 10 percent of Israel's per-capita income (World Bank, 2004). Although the West Bank and Gaza struggled with high unemployment and poverty throughout the 1990s, unemployment dropped to 10 percent (World Bank, 2000, p. 10) and the poverty rate dropped to 20 percent in 1999 (World Bank, 2002c, p. 8).³

The Palestinian economy is primarily oriented to providing services and producing nontradable goods. In 1999, service sectors, including government services, made

² By comparison, Israel in 2000 had a GDP of \$110.4 billion (World Bank, 2002a), Egypt in 2001 had a GDP of \$91.1 billion (World Bank, 2003a), and Jordan in 2000 had a GDP of \$8.5 billion (World Bank, 2003b).

³ Here, the World Bank uses a widely accepted definition of poverty as being household expenditures of less than \$2 per person, per day. World Bank obtains unemployment figures from the Palestinian Central Bureau of Statistics (PCBS), which defines unemployment according to International Labour Organization standards as follows:

Unemployed [Palestinian] persons are those individuals 15 years and over who did not work at all during the reference week, who were not absent from a job and were available for work and actively seeking a job during the reference week. [Palestinian] persons who work in Israel and were absent from work due to closure are considered unemployed, and also those persons [who] never work and [are] not looking for work but [are] waiting to return back to their [businesses] in Israel and [the] Settlements (PCBS, 2003).

up 63 percent of Palestinian GDP, including economic activity in East Jerusalem. The goods-producing sectors—mining, quarrying, and manufacturing (18 percent); construction (12 percent); and agriculture (7 percent)—constituted the remainder of GDP [Palestine Economic Policy Research Institute (MAS), 2000, p. 12]. Part of the difference in size between the service and goods-producing sectors stems from the structure of the manufacturing sector: It is dominated by small workshops that have little capital and that produce relatively unsophisticated goods. The disparity is also the result of a large public-sector apparatus. In 1999, public administration and services accounted for about 23 percent of all domestic employment, making it the largest segment in terms of employment.⁴ The next largest employers were commerce, hotels, and restaurants (18 percent); manufacturing and quarrying (16 percent); and agriculture and fishing (14 percent). The total Palestinian workforce numbered nearly 630,000 in that year.

The Palestinian economy is very dependent upon trade; as a matter of fact, the total value of traded goods and services (both imports and exports) is equal to its GDP. This high reliance on trade stems from the small size of the economy and from the West Bank and Gaza's limited resources: Palestinians depend largely on imports, almost all of which come from or go through Israel, for raw materials and intermediate goods.⁵ Palestinian merchandise trade runs heavily in deficit. Imports of goods and services were 81 percent of GDP in 1999, compared with only 18 percent for exports; imports as a share of GDP are the highest in the region. The resulting large trade deficit has traditionally been financed through wages earned abroad and through foreign aid; donor financing in the mid- to late 1990s was consistently between about 12 and 16 percent of GNI per year (Fischer, Alonso-Gamo, and von Allmen, 2001, pp. F256–F257).

A key feature of the Palestinian economy is its integration with the Israeli economy with respect to trade. Formalized in the Protocol on Economic Relations of 1994 (Paris Protocol), the West Bank, Gaza, and Israel form a customs union. The area imposes common (Israeli) tariffs, while Palestinian and Israeli goods are traded duty-free. In other words, Palestinian and Israeli goods receive preferential treatment in each other's markets, relative to the goods of other countries.

It is not surprising that Israel is the main trading partner of the West Bank and Gaza: In 1998, it accounted for 80 percent of the value of merchandise trade transactions (exports plus imports) with the West Bank and Gaza. In contrast, Jordan and Egypt (the second and ninth largest trading partners) accounted for only 2.4 percent and 1.0 percent, respectively, of total trade (UNSCO, 2000, p. 29). Palestinian trade with other countries often transits

⁴ The Palestinian public sector is large for the region as well. In 1997, the civilian central government in the West Bank and Gaza made up 14.5 percent of the labor force, compared with 12.4 percent for Egypt, 10.1 percent for Jordan, 4.2 percent for Lebanon, 5.6 percent for Morocco, and 10.5 for Tunisia (World Bank, 1999b, p. 55).

⁵ The West Bank and Gaza have little in the way of natural resources, necessitating imports of raw materials. In 1998, imports of energy and raw materials amounted to 29 percent of all imports. Investment goods (including those imported for donor-funded projects) ran 36 percent of imports (UNSCO, 2000, p. 28).

through Israel. Because Israel has a much larger economy and more developed economic relations with other countries, trade with Palestine is a much smaller proportion of Israel's total trade than of Palestine's total trade with Israel (MAS, 2001, p. 15).

Another historical feature of the Palestinian economy is the relatively large share of the labor force employed in Israel or Israel's settlements in the West Bank and Gaza. In 1999, higher Israeli wages and few domestic opportunities induced about 135,000 Palestinians, nearly 23 percent of the Palestinian labor force, to find employment in Israel or the settlements (MAS, 2000, p. 15). Most of these jobs involved relatively unskilled labor, such as for construction and agriculture.

Because of this dependence on Israel, the Palestinian economy is very vulnerable to Israeli policy decisions. Israeli security measures intended to deal with suicide bombings and shootings have repeatedly caused disruptions in production and labor and commodity flows, thereby severely affecting employment, income, and production in the West Bank and Gaza. Palestine is also very sensitive to economic shocks emanating from Israel. Recessions, periods of high inflation, and devaluations have an immediate impact on the Palestinian economy, although their effects have been moderated somewhat by Palestine's use of multiple currencies (rather than just the new Israeli shekel), which has helped to dampen inflation.⁶ These shocks, which introduce uncertainty and volatility into the business environment, have been important factors in limiting investment in economic sectors (except for residential construction) throughout the West Bank and Gaza. On the other hand, periods of boom in Israel have a corresponding positive effect on demand for Palestinian labor and on wages.

Palestinian Economic Development from 1967 to the Oslo Accords in 1993⁷

Israeli control over the West Bank and Gaza since 1967 has had profound effects on the development of the Palestinian economy. Before 1967, the economy of the West Bank was tied to Jordan's, and the economy of Gaza was integrated with Egypt's. Following Israel's occupation of the West Bank and Gaza in 1967, however, Israel created a de facto customs union incorporating the West Bank and Gaza's economy. High Israeli tariffs and many nontariff barriers, reinforced by political factors such as Arab boycotts of Israeli products (which extended to products from the West Bank and Gaza), diverted Palestinian commerce away from its Arab neighbors toward Israel.

However, integrating the West Bank and Gaza's smaller, poorer economy into the more-developed Israeli economy also produced a number of benefits for Palestinians: Technology transfer (especially in agriculture) helped income and economic growth in the West Bank and Gaza to outpace Israel's in the late 1960s and early 1970s. At that time, many predicted that the two economies would eventually converge. By the late

⁶ The West Bank and Gaza do not have their own currency but instead use three freely exchanged foreign currencies: the new Israeli shekel, the U.S. dollar, and the Jordanian dinar.

⁷ This subsection is based on Naqib (2002) and World Bank (1999a, pp. 1–13).

1980s, over one-third of the West Bank and Gaza labor force commuted daily to Israel and the settlements, drawn by higher wages.

Economic growth in the West Bank and Gaza began to slow in the mid-1970s, in part because of Israeli policies and actions that restricted Palestinian commerce. Israel blocked some Palestinian goods from being exported to Israel while simultaneously promoting its own goods in Palestinian markets. Israel used water and land from the West Bank and Gaza for roads, settlements, and security purposes. Infrastructure investment in the West Bank and Gaza lagged that in Israel. These policies and the disruption of the Palestinian financial sector caused by the closure of Arab-owned banks in the West Bank and Gaza hurt economic development. Through the 1980s, the development of manufacturing industries in the West Bank and Gaza was very slow. Exports consisted mostly of unsophisticated, labor-intensive manufactured goods (e.g., furniture and textiles) produced under subcontracting arrangements with Israeli companies and a narrow range of agricultural products and building materials.

The West Bank and Gaza have been characterized by underemployment and an exodus of labor, especially people with better skills. While many less-skilled Palestinian workers commuted to Israel to work in construction and agriculture, a large group of highly educated, highly skilled workers left the West Bank and Gaza to seek employment in other countries. During the oil boom of the 1970s, the countries of the Persian Gulf provided an especially attractive market for Palestinian labor. However, worker remittances from the Gulf declined in the late 1980s as the oil boom collapsed. The onset of the first intifada in 1987 and the accompanying Palestinian labor strikes and Israeli security restrictions resulted in a decline in Palestinian employment in Israel and the settlements. New requirements that Palestinian workers in Israel and the settlements obtain work permits limited the extent of the rebound in employment following the end of the first intifada. Palestinian workers suffered a further blow when Kuwait and other Persian Gulf states expelled them during and after the first Gulf War, as a response to support for Iraq by the Palestinian Liberation Organization.

Palestinian Economic Development from the Oslo Accords to 1999⁸

The Oslo Accords brought limited self-rule to the Palestinians as well as expectations of rapid economic development. The Paris Protocol of 1994, one element of the accords, transferred control over much of the Palestinian economy from Israel to the Palestinian Authority (PA). The Paris Protocol also modified the customs union to allow for the free entry of almost all Palestinian goods into Israel. (Remaining restrictions on some agricultural products were completely removed by 1998.) The protocol permitted the use of the Jordanian dinar as legal tender in addition to the new Israeli shekel. It also established the Palestinian Monetary Authority to regulate the financial system, which included reopened Arab banks. Tax collection, which had been a focus of Palestinian

⁸ This subsection is based on World Bank (1999a, pp. 17–32), UNSCO (2000, 2001a, 2001b), United Nations Conference on Trade and Development (UNCTAD) (1998), and MAS (2001).

resistance during the first intifada, improved: The PA received reimbursements for income taxes collected from Palestinians legally working in Israel, for import duties on goods destined for the West Bank and Gaza, and for value-added taxes on products purchased in Israel by Palestinian firms.

During the post-Oslo period, the public sector grew rapidly because of the establishment of the PA and government institutions. Indeed, most of the growth in Palestinian domestic employment since 1993 is due to growth in the public sector.

However, the Oslo Accords did not markedly alter sovereignty over land and water resources. Negotiations on these issues were postponed until final status talks. Although responsibility for major Palestinian population centers was transferred to the PA, 40 percent of the land in Gaza and 60 percent of the West Bank remained under Israel's direct control, resulting in continued Israeli authority over building, zoning, and land registration. The areas under Israeli control included the Jordan River Valley, which affected development of Palestinian agriculture; and the Dead Sea coast, which affected development of Palestinian tourism and of the chemicals industry. Overall, the unresolved issue of water rights limited the water available for agriculture and raised its cost for industrial and residential purposes.

Israel also retained full control over all borders: Israel effectively controlled the movement of goods and labor among the West Bank, Gaza, and Israel. Continued allocation of land for Israeli settlements and the construction of bypass roads for exclusive use by Israelis further divided the domestic landscape, increasing transportation delays and transaction costs.

Israeli security concerns led to burdensome regulations governing the transportation of goods among the West Bank, Gaza, and Israel (and neighboring countries) and occasionally led to severe restrictions on movement within the territories and to border closures. These measures, a reaction to Palestinian suicide bombings, were first introduced in early 1993 and were used more frequently and broadly in 1996 and 1997. They greatly increased transaction costs for commerce and increased investor uncertainty. Thus, despite the expansion of the domestic banking system and increased donor funds between 1993 and 1996, the real value of private investment spending declined by about 38 percent during the same period.

During this same period, a more restrictive Israeli policy concerning the number of Palestinians working in Israel, also taken in response to suicide bombings, reduced the number of Palestinians employed in Israel or the settlements from about 120,000 in 1992 to fewer than 25,000 in 1996. Border closures were the main factor behind an estimated 18 percent decline in real gross national product (GNP) and a 35 percent decline in per-capita GNP during this same period.⁹

⁹ By contrast, an increase in private investment between 1998 and 2000, particularly in agriculture and tourism-related industries, coincided with a reduction in border closures and yielded a short period of economic recovery.

Even during the initial period of rapid growth following the signing of the Oslo Accords, increases in industrial output were modest. In contrast, increases in construction activity, particularly construction of infrastructure, were a major driver of economic growth after the adoption of the Paris Protocol. Service sectors also prospered. The positive atmosphere created by the peace process encouraged tourism, expanding employment in hotels and restaurants. However, growth in tourism ended after the suicide bombings and repeated border closures of 1996.

Overall, Palestinian expectations of rapid economic development following the Oslo Accords were largely not borne out, despite greater autonomy. Although real GDP grew 20 percent between 1993 and 1999, per-capita GDP declined by about 8 percent; disposable income, which includes income from abroad and current account transfers, grew only 4 percent (Fischer, Alonso-Gamo, and von Allmen, 2001).

The Palestinian Economy Under the Current Intifada¹⁰

The second intifada began in September 2000. The period from then through the time of this writing has included Palestinian attacks on Israelis in Israel and the West Bank and Gaza; Israeli military action in the West Bank and Gaza; and Israeli restrictions on Palestinian travel to Israel, between the West Bank and Gaza, and within the West Bank. Since this intifada began, the Palestinian economy has been severely damaged: In 2002, GNI was only 60 percent of its 2000 level. The total losses in GNI from September 2000 to December 2002 ran \$5.4 billion, equivalent to the West Bank and Gaza's entire GNI in 1999. The poverty rate rose to 60 percent, up from 20 percent in 1999. Emergency donor aid to the PA has provided some relief through the provision of temporary employment and the maintenance of social services. However, as a result of a 9 percent increase in the West Bank and Gaza's population, real per-capita income in 2002 was only half of its September 2000 level.

This drop in income is mainly attributable to greatly reduced employment of Palestinians in Israel and in Israeli settlements in the West Bank and Gaza, limitations on movement for people and goods within the West Bank and Gaza, and the destruction and depreciation of Palestinian infrastructure. By the end of 2002, the number of Palestinian workers in Israel and the settlements had fallen from 128,000 in 2000 to 16,000. As a result, unemployment at the end of 2002 stood between 42 and 53 percent of the workforce, up from 10 percent in the third quarter of 2000. The closures also affected Palestinian trade: Between June 2000 and June 2002, Palestinian exports declined in value by 45 percent and imports contracted by a third.

Damage from the violence to Palestinian infrastructure (i.e., roads, water, sanitation, power and communications systems, and public buildings) and the commercial sector has been significant. Estimated physical capital losses from the conflict stood at

¹⁰ This subsection is based on World Bank (2003c). Timely data on economic conditions in the West Bank and Gaza are quite limited. The current intifada and Israeli responses have limited the functioning of the PA and inhibited data collection and the maintenance of national accounts.